

ACCOUNT ADMINISTRATION: CORPORATE TRUST ACCOUNTS

Corporate trust and agency services performed by a bank normally concern some aspect of the issuance, redemption, transfer or recordkeeping regarding debt (bonds) or equity (common or preferred stock) securities. It is not uncommon for the trust agreement (indenture) to be the creating instrument for both the corporate trust and related corporate agencies. Performance as a trustee under a bond indenture is normally the only true trust relationship administered by a corporate trust department. Under the indenture, there is only one trustee for a given bond issue but several agents or co-agents may be created to serve the same issue. Corporate agencies, paying agencies, dividend reinvestment agencies and depository agencies. A brief description of each of these types of accounts administered by the corporate trust section of a bank's trust department follows.

A. CORPORATE TRUSTEE

The document which creates the corporate trust is called a trust indenture, a trust agreement, an indenture or simply an agreement. The indenture defines: The purpose(s) and/or nature of the debt to be created; The relationship between the corporation (borrower or obligor), the bank (trustee and/or agent) and lender(s) (bondholder(s)); Nature and description of the bonds to be issued; Parameters of administration during the life of the bonds; Nature, method and place of repayment of principal and interest; Duties of respective parties to the indenture; Description of collateral; A default; and Actions to be taken in the event of default. Indentures tend to be of uniform construction and design, but may be tailored to include unique provisions. Although the terms "corporate" and "corporation" are used universally to describe this type of service, the obligor under an indenture may be a private corporation, a state, county or municipal government, a quasi-public authority, a school, a church or some similar organization which has a need to raise funds through the sale of bonds. Associated with the indenture is the instrument which perfects a lien on collateral if any. These instruments are called a trust mortgage, deed of trust, collateral trust, equipment trust, etc., depending on the type of collateral tendered by

the obligor. Unsecured bonds are called debentures. The primary duty of the trustee under the indenture is to perform the duties specified which include the following: Holding beneficial title to collateral (if any); Arranging for the printing and issuance of the bond instruments; Maintaining required records, accounts and documentation; Monitoring for default under the indenture during the life of the bonds; Identifying and reacting properly when a default occurs; Safeguarding and appraising collateral; Performing investment discretion; Ensuring that legal prerequisites are in compliance; and Effecting payment of principal and interest. Bonds issued under an indenture may be sold to the general public, a limited investor group or a single investor such as an insurance company or governmental agency. Bonds may be registered, mature serially or have a single maturity, be called or callable for payment at specified times, be convertible into other types of securities, or may include aspects of some or all of the described features.

B. STOCK TRANSFER AGENT

A transfer agent issues stock certificates which constitute an increase in shares outstanding, i.e., original issues, stock dividends and splits, etc., and performs the functions of cancellation and reissuance of certificates to reflect changes in ownership. In connection with the latter, certificates submitted are checked for authenticity and appropriate accompanying documents, cancelled, and new certificates issued. The transfer agent sends the cancelled certificates and corresponding newly issued certificates to the registrar for verification. This involves only an in-house transmittal when the institution acts both as transfer agent and registrar. After registration, the newly issued certificates are sent to the registered owners or their representatives and appropriate disposition is made of the cancelled certificates. The transfer agent usually maintains a "shareholder record" which is a listing of the registered owners of all outstanding certificates.

Transfer agents servicing securities registered under Section 12 of the Securities Exchange Act of 1934, as amended (the Act), and certain other securities, are required to register. Part 341 of the Corporation's Rules and Regulations prescribes the manner of registration by state nonmember insured banks. Once subject to registration,

whether registered or not, the bank becomes subject to operating and recordkeeping rules promulgated by the Securities and Exchange Commission (SEC). Enforcement of the governing laws and regulations is a Corporation obligation imposed under the Act. Examination of the functions and activities of registered transfer agent banks is to be performed in accord with standing memorandum instructions. A separate report is utilized to present examination findings.

C. TRANSFER AGENT FOR REGISTERED BONDS (BOND REGISTRAR)

Historically Government and municipal bonds have been issued as bearer instruments; however, practically all corporate indentures provide for the registration of bonds as to principal and most provide for registration as to both principal and interest thereby necessitating the performance of transfer functions. By amendment to the Internal Revenue Code, the interest earned on state, county and municipal bonds issued in bearer (coupon) form, with limited specific exceptions, on or after July 1, 1983, is no longer exempt from Federal income taxes. Other tax sanctions are also imposed. Consequently, while the issuance of municipal bonds in bearer form is legal, no economic benefit to the issuer or bondholder(s) would result and the issuance of these securities in registered form is thereby mandated. The duties of a transfer agent for bonds (bond registrar) are substantially the same as the duties of a stock transfer agent.

It should be noted that in instances where the bank functions as a "registered transfer agent" the registered bonds (corporate and municipal) it receives for reregistration are to be included in its count of items received for transfer to determine qualification for exemption as a "small" transfer agent. Other SEC interpretations of its rules governing registered transfer agents required that identical turnaround times be met for registered bonds as are mandated for equity securities.

D. REGISTRAR

As registrar of stock, an institution performs the important duty of guarding against overissuance. In addition to checking original issues, the registrar checks each transfer made by the transfer agent to ensure genuineness of the certificates presented for transfer, make certain

that old certificates are cancelled, and see that the number of shares represented by the new certificates does not exceed the number of shares represented by the old (cancelled) certificates. In the case of bonds, this function is performed by the indenture trustee. New York Stock Exchange rules permit one institution to act as both transfer agent and registrar for listed securities other than its own.

E. FISCAL OR PAYING AGENT

As fiscal agent for corporations and municipalities, an institution makes interest payments on coupon bonds (often referred to as bearer bonds) as the coupons are presented, redeems maturing bonds, prepares and mails interest checks for registered bonds and dividend checks for stock issues. A fiscal agent is called dividend disbursing agent, coupon and bond paying agent or some similar name indicative of its duties.

F. DIVIDEND REINVESTMENT

Some corporations offer their stock holders the option of participating in dividend reinvestment programs whereby dividends are automatically applied to the purchase of additional shares of the corporation on the open market or directly from the corporation. On the dividend payment date, dividends due each participating stockholder are paid by the dividend disbursing agent to the dividend reinvestment agent (often the same institution) and used to purchase shares of the corporation. It is also possible to subscribe for additional shares. The shares purchased are usually held by the dividend reinvestment agent until the participating stockholder requests delivery.

G. OTHER AGENCIES

Institutions may serve also as escrow agent or depository in connection with defaults, mergers, consolidations, reorganizations, tender offers, or other transactions which require that such items as outstanding equity or debt securities be deposited with a responsible and disinterested party. The depository may also receive and record the claims of creditors.

Common are bank appointments as conversion agent (where debt securities are "converted" into

equity securities), exchange agent (involving exchange of one class of securities for another or exchange of bearer bonds for registered bonds and vice versa), subscription agent (usually involving an invitation to equity security holders to subscribe to a new issuance of additional debt or equity) and authenticating agent (commonly used when the indenture trustee is not located in a major money market city -- the bond registrar is also able to exercise limited authority to authenticate bonds on exchange or transfer).

Lesser known services offered to corporations are in connection with the voluntary and involuntary liquidation of business enterprises. A business concern which finds itself in financial difficulties but is not insolvent, may turn over its assets to a trust institution as assignee for the benefit of creditors. A concern in financial difficulties which can effect no compromise with its creditors may end up with a court appointed receiver to operate the business until such time as the assets can be liquidated or it becomes evident that bankruptcy can be averted. The duty of a trustee in bankruptcy is to realize as much cash as possible from the sale of assets of a bankrupt business and, under the direction of the court, to apply the amount realized to the claims of creditors. Few institutions accept trusteeships in bankruptcy because of the undesirable and unprofitable nature of this type of business.

H. ADMINISTRATION

The administration of corporate trusteeships and agencies generally requires fewer discretionary decisions and actions than do personal trusteeships. However, they do require a higher level of documentation mechanically programmed services, and an in-depth knowledge of securities, security related loans, industry practices, etc. Duties and actions are specified in the indenture and the corporate trustee/agent is limited to the parameters of the indenture and assumes or performs additional duties and functions at its own risk. Normally accounting records are specified by the agreement in that certain accounts and funds must be maintained during the life or some portion of the bond issue. The trustee/agent must maintain accurate tickler files for actions required at certain time periods. The trustee must not only provide reports and recordkeeping for the obligor but must also protect the interests of the bondholders. These

responsibilities are important since the trustee can be held liable if the bonds default and subsequent loss is attributable to the trustee's negligence. The acts of commission and omission by the trustee are critical in the event of default. Extreme care must be taken by the trustee regarding the timing of collateral foreclosure so that the interests of all parties to the indenture are fairly served. It is important to realize that a trustee's failure to perform properly in protecting the bondholders before and subsequent to a default can result in liability and loss to the trustee that frequently is not assessed by the courts until years later. Should the trustee prematurely foreclose on collateral, liability may be incurred by the obligor. If foreclosure is inordinately delayed, severe loss of value may be suffered by bondholder interests. Performance of corporate agencies requires adequate recordkeeping and efficient operational procedures.

One of the most important characteristics of good corporate trust administration occurs before accounts are accepted. The decision or decision-making process of whether or not to accept corporate trusteeship or agency accounts is of primary importance. Factors to be considered include: the financial strength of the obligor, both currently and anticipated over the life of the bond issue; the size and character of the issue; the capacity and capability of the corporate trust department to perform its duties and fulfill all responsibilities based on a thorough analysis of the requirements of the indenture; and the probability of profitable administration to the department.

The trustee must also exercise precaution that it does not have any conflicts of interest which would prevent it from acting with undivided loyalty or the perception of undivided loyalty. For issues subject to the Trust Indenture Act of 1939, prohibited conflicts must be identified in the indenture. For other issues, the question of conflicts of interest is still of importance and trustees have been held liable where it was felt they acted for their own benefit rather than that of the bondholders. A situation to be avoided is where a bank is both a corporate trustee and a creditor of the obligor. In the instance of an obligor's insolvency and default under the indenture and a bank is both a creditor and a trustee under bond indentures, the question arises whether the bank can serve its

stockholders (attempts to improve the bank's credit position or chances of repayment) and its responsibility to the bondholders in protecting their interest. Generally, such situations present a tenuous position for the bank. Such relationships should be identified and resolved prior to acceptance and reviewed during the life of the bond issue. Some banks make prior arrangements to resign in favor of another trustee in the event of default. Each bank engaged in administering corporate trust/agency accounts should formulate and adopt policies which address account acceptance, administration parameters and profitability standards.

I. EXAMINATION PROCEDURES

The basic fundamentals of examination procedures for corporate and personal trust accounts are the same, but with noted differences in terminology and recordkeeping procedures. Prior to commencing an examination, it is important for the examiner to review the previous report of examination and related correspondence. Examiners should be aware of potential size of the department and unique factors and/or identified problems so that personnel requirements and examination scope can be ascertained and necessary provisions made.

The bank's corporate trust department frequently has little operational relationship to the personal trust department and often maintains a uniquely separate set of books and records. It is not uncommon for the books of the personal trust department to be automated while books of the corporate trust department are manually posted. Therefore, in gaining control of the books, records and assets of the trust department, it is important to specifically address the possibility of corporate trust department separability.

Detailed below are the procedures to be followed regarding examination of specific corporate trust department capacities.

Trustee for Bond Issues - Complete documentation for each trust indenture is of primary importance. In this regard, a listing of documentation items is included in this Manual under Appendix B - Examination Aids. Without exception, banks should not accept accounts without obtaining the necessary documentation

as depicted on the corporate account line sheet. In view of the fact that the corporate trustee's name is associated with that of the issuing company by reason of their close legal connection, the bank should not accept any trusteeship until a careful investigation has been made of the bond issue the financial stability of the issuing corporation. An assessment must also be made as to the trust department's capability and capacity to administer the indenture.

The examiner should analyze the trust indenture and compare its provisions with the bank's administration. Examiners will be particularly interested in: Provisions regarding redemption of the bonds; Funding instructions for specialized funds (i.e. depreciation, maintenance, or reserve funds, etc.); Terms of sinking fund arrangements; Insurance requirements; Investment discretion; Termination provisions; Specialized reports required; Protective clauses accorded to the trustee; and Actions to be taken under the events of default provisions of the indenture.

The examiner must determine that all securities turned over to the trust department have been accounted for and reconciled. Reconciliation is usually made to the engraver's certificate which reflects the total number (not always amount) of bonds engraved and to whom delivered. The trustee should maintain adequate control and records regarding paid bonds and coupons, blank certificates, certificates submitted for reregistration, and certificates replaced as the result of mutilation.

The examiner should check the adequacy of collateral documentation. To be determined are that insurance policies on insurable collateral are of sufficient amount, with premiums paid and the trustee shown as loss payee. Collateral liens and related documentation papers should be properly filed, recorded and maintained. Collateral consisting of stocks, bonds, or other instruments should be in sufficient amount and of specified quality and type.

Investment of idle funds should be in accordance with the governing instrument. As in all areas of fiduciary administration, the bank should formulate and have adopted by the Trust Committee and board of directors written policies regarding account acceptability, conflicts

of interest, internal operations, auditing and account/department profitability.

Corporate Agencies - The administration of corporate agencies does not encompass discretion but does require accurate recordkeeping, promptly posted accounting records, timely reporting, and individuals who are thoroughly trained in related laws, regulations and standard industry practices.

When the bank is serving as a paying agent, the obligor deposits the necessary amount of funds with the trustee (bank) and the bank prepares and issues checks in payment of the interest, dividends or bonds. When bonds are fully registered, an interest check is sent to the holder of record. In the case of coupon bonds, the coupons are presented for payment. Coupons are received in several ways but normally flow through the banking system and the related clearing house process.

The amount deposited by the obligors for the payment of interest or dividends should be scheduled and separately booked. Funds for payment of interest of differing coupons or differing dividends should not be pooled but segregated. Interest or dividends from one payment period should not be used to pay interest or dividends of any other payment period. Charges against payment deposits should be verified by checking receipts for the return of cancelled coupons and checks and paid coupons and checks on hand. The difference represents outstanding items and should equal the total amount at the date of examination. It is not uncommon for dividend paying accounts and coupon paying accounts not to be included on the corporate trust department's books but reside as an account in the demand deposit ledger of the commercial department. Management should be encouraged to include these accounts on the books of the corporate trust department. These accounts should also be periodically reconciled both as a routine operational procedure and by independent auditing personnel. The examination should include an analysis of the department's reconciliation procedures. A company for whom the bank is acting as paying agent is not entitled to a return of unclaimed interest or dividends.

The performance of agencies requires technical expertise, timely reporting, prompt posting of

accounts, open communication between interested parties, and an efficient operating system. As in all other aspects of fiduciary operations, the corporate agency function should be fully covered by written policies approved by the trust committee and board of directors.

J. APPLICABLE LAWS AND REGULATIONS

Laws and regulations in the corporate trust area are very technical and require a high level of knowledge and training for anyone engaged in administration or examination. These laws and regulations are augmented by standard practices in the industry and unique laws and regulations of the various stock exchanges. Some specifically require certain performance levels of individuals involved in the corporate trust and agency area. Texts for each of the following laws and regulations, which are among those most frequently encountered, are included in the FDIC Reporting Service. Except for Part 341 of the Corporation's Rules and Regulations, each will be found under the caption of Miscellaneous Statutes and Regulations in Volume II.

Securities Act of 1933 - This law is too far reaching to be adequately described here, however, it is important that some familiarity with its intent and purpose be identified. The stated purpose of this Act is to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes. It is important that the Corporate trustee secure opinions from legal experts in this field regarding the compliance or any particular trust indenture with the provisions of the Act.

Securities Exchange Act of 1934 - The stated purpose of this Act is to provide for the regulation of securities exchanges and over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets. Parts 335, 341, 343 and 344 of the FDIC Rules and Regulations are closely related to provisions of this Act and impose certain portions of the Act on the activities of commercial banks. It is important that opinions be obtained from legal experts in this field regarding compliance of any particular trust indenture with the provision of this Act.

Trust Indenture Act of 1939 - The Trust Indenture Act of 1939 (Act) imposes stringent duties on the issuer (obligor) and the trustee of indenture securities subject to the law. Requirements for registration and exemption under the Act are provided by Section 304. Specific provisions regarding conflicts of interest are identified under Section 310. Familiarity with the provision of this Act is imperative for both the corporate trust account administrator and the examiner to assure the proper performance by each of their respective duties. Legal opinions regarding an indenture's compliance with the Act or outlining the qualifications for exemption of an indenture from the requirements of the Act should be on file for examiner review.

Investment Company Act of 1940 - Under this Act, the activities of companies engaged primarily in the business of investing, reinvesting and trading in securities, and whose own securities are held by the public are subject to statutory limitations and to SEC regulations in accordance with prescribed standards deemed necessary to protect the interests of investors and the public. The law prohibits such companies from changing the nature of their business or their investment policies without the approval of their shareholders. In addition it: Bars persons guilty of securities frauds from serving as officers and directors; Prevents underwriters, investment bankers or brokers from constituting more than a minority of such companies' managements; Requires management contracts (and material changes thereto) to be submitted to security holders for their approval; Prohibits transactions between such companies, their directors, officers or affiliated companies or persons, except upon approval of the SEC as being fair and involving no overreaching; forbids issuance of senior securities by such companies except under specified conditions and upon specified terms; and Prohibits pyramiding of such companies and cross ownership of their securities. Other provisions relate to sales and repurchases of securities issued by investment companies, including special provisions for periodic payment plans and face amount certificate companies.

Part 341 - Registration of Transfer Agents - Part 341 of the FDIC Rules and Regulations provides for the registration of transfer agents. This regulation applies to all State nonmember

banks which act as transfer agent for securities registered under Section 12 of the Securities Exchange Act of 1934 or for securities which would be required to be registered under Section 12 of the 1934 Act except for the exemption contained in subsections (g)(2)(B) or (g)(2)(C) which relate to securities of investment companies and insurance companies. Generally, registration is required pursuant to Section 12(a) if the security is listed and traded on a national securities exchange. Registration is also required pursuant to Section 12(g) if the issuer has total assets as of the end of its fiscal year exceeding \$1,000,000 and there are 500 or more holders of record of any class of equity security of the issuer.

Bookkeeping and Turnaround Requirements - On June 16, 1977, the Securities and Exchange Commission adopted rules applicable to all registered transfer agents. These rules, as amended (17 CFR Sections 240.17Ad-1 through 240.17Ad-13) are designed to facilitate establishment and maintenance of a national system for the prompt and accurate clearance and settlement of transactions in securities. The major provisions require registered transfer agents to turnaround within three business days at least 90% of all routine items received for transfer during a month, respond to certain written inquiries within five business days and maintain specific records. Nonmember insured banks which receive fewer than 500 items for transfer and fewer than 500 items for processing (registrar activity) in any six consecutive months and which have filed a notice with the FDIC to that effect, qualify as an "exempt transfer agent" (small transfer agent). Small transfer agents are exempt from certain of the turnaround, recordkeeping and annual audit requirements of these rules.

Fingerprinting of Registered Transfer Agent Personnel - Rule 17f-2 (17 CFR Sections 240.17f-2(a) through 240.17f-2(e)) under the Securities and Exchange Act of 1934 was adopted by the SEC, effective July 1, 1976, and extensively amended on November 22, 1982. The Rule requires all persons engaged in transfer agent activities to be fingerprinted and to submit or cause fingerprints to be submitted to the Attorney General of the United States for identification and appropriate processing, unless specifically exempted under the Rule. Personnel of registered transfer agents who regularly have

access to the keeping handling or processing of securities, monies, or the original books and records relating to the securities or monies and those who have direct supervisory responsibility over persons engaged in these activities must be fingerprinted. Nonexempt transfer agents are required to prepare and retain a current statement entitled "Notice Pursuant to Rule 17f-2" detailing those classes of persons who fall within the listed exemptions and who seek to be exempted from the fingerprinting requirements. "Small" transfer agents, i.e., those who receive fewer than 500 items for transfer and fewer than 500 items for processing and who have filed a notice with the FDIC to that effect, and which transfer only their own stock or that of the bank's holding company are not required to prepare and maintain a "Notice Pursuant to Rule 17f-2".

activities) and standardized operating procedures within the securities industry.

Lost, Stolen and Counterfeit Securities - SEC Rule 17f-1 (17 CFR Sections 240.17f-1(a) through (g)), effective October 3, 1977, as amended, established a central data base for the collection and dissemination of information about lost, stolen and counterfeit securities. All insured banks must be registered with the Securities Information Center, Inc. (SIC) as either a direct inquirer or indirect inquirer and must report to the SIC each instance in which securities are missing, lost, stolen or discovered to be counterfeit. Banks are also required to make routine inquiries coming into their possession. Inquiries will most likely be required for securities coming into the bank's trust department. Although registered transfer agents are exempt from the inquiry requirements, they are subject to the reporting requirements.

State Escheat Laws - These laws vary from one state to another and many not exist in others. However, it is important that some procedure be in force to assure compliance. Funds on deposit to pay unclaimed dividends, bond coupons not presented for payment, bonds not presented for payment, and certain suspense accounts are prime candidates for escheat.

Other Laws and Regulations - There are various other laws and regulations affecting the administration of accounts in a corporate trust department, such as bankruptcy laws, exchange rules and regulations, Municipal Securities Dealers Regulations (refer to the Corporation's handbook covering municipal securities dealer